

Internal Revenue Service, Treasury

§ 1.475(b)-1

M-1 or Schedule M-3 must reconcile net income using substitute schedules similar to Schedule M-1 and Schedule M-3, and these substitute schedules must be attached to the return.

(B) *Values on books and records with supporting schedules.* The books and records must state the value used for each eligible position separately from the value used for any other eligible position. However, an eligible taxpayer may make adjustments to values on a pooled basis, if the taxpayer demonstrates that it can compute gain or loss attributable to the sale or other disposition of an individual eligible position.

(C) *Consolidation schedules.* An eligible taxpayer must provide a schedule showing the consolidation and de-consolidation that is used in preparing the applicable financial statement, along with exhibits and subordinate schedules. This schedule must provide information that addresses the differences for consolidation and de-consolidation between the applicable financial statement and the Federal income tax return.

(ii) *Instructions provided by the Commissioner.* The Commissioner may provide an alternative time or manner in which an eligible taxpayer subject to this paragraph (k) must establish that the same values used for eligible positions on the applicable financial statement are also the values used for purposes of section 475 on the Federal income tax return.

(3) *Time for producing records.* All documents described in this paragraph (k) must be produced within 30 days of a request by the Commissioner, unless the Commissioner grants a written extension. Generally, the Commissioner will exercise his discretion to excuse a minor or inadvertent failure to provide requested documents if the taxpayer shows reasonable cause for the failure, has made a good faith effort to comply with the requirement to produce records, and promptly remedies the failure. For failures to maintain, or timely produce, records, see paragraph (f)(3)(ii) of this section (allowing the Commissioner to revoke the election), and see paragraph (m) of this section (allowing the Commissioner, but not the taxpayer, to use for eligible posi-

tions that otherwise might be subject to the safe harbor fair market values that clearly reflect income but that are different from the values used on the applicable financial statement).

(4) *Retention period for records.* All materials required by this paragraph (k) and section 6001 must be retained as long as their contents may become material in the administration of any internal revenue law.

(5) *Agreements with the Commissioner.* The Commissioner and an eligible taxpayer may enter into a written agreement that establishes, for purposes of this paragraph (k), which records must be maintained, how they must be maintained, and for how long they must be maintained.

(l) [Reserved]

(m) *Use of different values.* If, with respect to the records that relate to certain eligible positions for a taxable year, the taxpayer fails to satisfy paragraph (k) of this section (concerning record retention and record production), then, for those eligible positions for that year, the Commissioner may use values that the Commissioner determines to be fair market values that are appropriate to clearly reflect income, even if the values so determined are different from the values reported for those positions on the applicable financial statement. See also paragraph (f)(3)(ii) of this section (concerning revocation of the election by the Commissioner when a taxpayer does not produce required records and fails to demonstrate reasonable cause for the failure).

[T.D. 9328, 72 FR 32177, June 12, 2007]

§ 1.475(b)-1 Scope of exemptions from mark-to-market requirement.

(a) *Securities held for investment or not held for sale.* Except as otherwise provided by this section and subject to the identification requirements of section 475(b)(2), a security is held for investment (within the meaning of section 475(b)(1)(A)) or not held for sale (within the meaning of section 475(b)(1)(B)) if it is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(b) *Securities deemed identified as held for investment*—(1) *In general.* The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(i) Except as provided in paragraph (b)(3) of this section, stock in a corporation, or a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, to which the taxpayer has a relationship specified in paragraph (b)(2) of this section; or

(ii) A contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract (see sections 72, 817, and 7702).

(2) *Relationships*—(i) *General rule.* The relationships specified in this paragraph (b)(2) are—

(A) Those described in section 267(b)(2), (3), (10), (11), or (12); or

(B) Those described in section 707(b)(1)(A) or (B).

(ii) *Attribution.* The relationships described in paragraph (b)(2)(i) of this section are determined taking into account sections 267(c) and 707(b)(3), as appropriate.

(iii) *Trusts treated as partnerships.* For purposes of this paragraph (b)(2), the phrase partnership or trust is substituted for the word *partnership* in sections 707(b)(1) and (3), and a reference to beneficial ownership interest is added to each reference to capital interest or profits interest in those sections.

(3) *Securities traded on certain established financial markets.* Paragraph (b)(1)(i) of this section does not apply to a security if—

(i) The security is actively traded within the meaning of § 1.1092(d)-1(a) taking into account only established financial markets identified in § 1.1092(d)-1(b)(1) (i) or (ii) (describing national securities exchanges and interdealer quotation systems);

(ii) Less than 15 percent of all of the outstanding shares or interests in the same class are held by the taxpayer and all persons having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section; and

(iii) If the security was acquired (e.g., on original issue) from a person having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section, then, after the time the security was acquired—

(A) At least one full business day has passed; and

(B) There has been significant trading involving persons not having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section.

(4) *Changes in status*—(i) *Onset of prohibition against marking.* (A) Once paragraph (b)(1) of this section begins to apply to the security and for so long as it continues to apply, section 475(a) does not apply to the security in the hands of the taxpayer.

(B) If a security has not been timely identified under section 475(b)(2) and, after the last day on which such an identification would have been timely, paragraph (b)(1) of this section begins to apply to the security, then the dealer must recognize gain or loss on the security as if it were sold for its fair market value as of the close of business of the last day before paragraph (b)(1) of this section begins to apply to the security, and gain or loss is taken into account at that time.

(ii) *Termination of prohibition against marking.* If a taxpayer did not timely identify a security under section 475(b)(2), and paragraph (b)(1) of this section applies to the security on the last day on which such an identification would have been timely but thereafter ceases to apply—

(A) An identification of the security under section 475(b)(2) is timely if made on or before the close of the day paragraph (b)(1) of this section ceases to apply; and

(B) Unless the taxpayer timely identifies the security under section 475(b)(2) (taking into account the additional time for identification that is provided by paragraph (b)(4)(ii)(A) of this section), section 475(a) applies to changes in value of the security after the cessation in the same manner as under section 475(b)(3).

(iii) *Examples.* These examples illustrate this paragraph (b)(4):

Example 1. Onset of prohibition against marking. (A) *Facts.* Corporation H owns 75 percent

of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). On December 1, 1995, *D* acquired less than half of the stock in corporation *X*. *D* did not identify the stock for purposes of section 475(b)(2). On July 17, 1996, *H* acquired from other persons 70 percent of the stock of *X*. As a result, *D* and *X* became related within the meaning of paragraph (b)(2)(i) of this section. The stock of *X* is not described in paragraph (b)(3) of this section (concerning some securities traded on certain established financial markets).

(B) *Holding*. Under paragraph (b)(4)(i) of this section, *D* recognizes gain or loss on its *X* stock as if the stock were sold for its fair market value at the close of business on July 16, 1996, and the gain or loss is taken into account at that time. As with any application of section 475(a), proper adjustment is made in the amount of any gain or loss subsequently realized. After July 16, 1996, section 475(a) does not apply to *D*'s *X* stock while paragraph (b)(1)(i) of this section (concerning the relationship between *X* and *D*) continues to apply.

Example 2. Termination of prohibition against marking; retained securities identified as held for investment. (A) *Facts*. On July 1, 1996, corporation *H* owned 60 percent of the stock of corporation *Y* and all of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). Thus, *D* and *Y* are related within the meaning of paragraph (b)(2)(i) of this section. Also on July 1, 1996, *D* acquired, as an investment, 10 percent of the stock of *Y*. The stock of *Y* is not described in paragraph (b)(3) of this section (concerning some securities traded on certain established financial markets). When *D* acquired its shares of *Y* stock, it did not identify them for purposes of section 475(b)(2). On December 24, 1996, *D* identified its shares of *Y* stock as held for investment under section 475(b)(2). On December 30, 1996, *H* sold all of its shares of stock in *Y* to an unrelated party. As a result, *D* and *Y* ceased to be related within the meaning of paragraph (b)(2)(i) of this section.

(B) *Holding*. Under paragraph (b)(4)(ii)(A) of this section, identification of the *Y* shares is timely if done on or before the close of December 30, 1996. Because *D* timely identified its *Y* shares under section 475(b)(2), it continues after December 30, 1996, to refrain from marking to market its *Y* stock.

Example 3. Termination of prohibition against marking; retained securities not identified as held for investment. (A) *Facts*. The facts are the same as in *Example 2* above, except that *D* did not identify its stock in *Y* for purposes of section 475(b)(2) on or before December 30, 1996. Thus, *D* did not timely identify these securities under section 475(b)(2) (taking into account the additional time for identification provided in paragraph (b)(4)(ii)(A) of this section).

(B) *Holding*. Under paragraph (b)(4)(ii)(B) of this section, section 475(a) applies to changes in value of *D*'s *Y* stock after December 30, 1996, in the same manner as under section 475(b)(3).

Thus, any appreciation or depreciation that occurred while the securities were prohibited from being marked to market is suspended. Further, section 475(a) applies only to those changes occurring after December 30, 1996.

Example 4. Acquisition of actively traded stock from related party. (A) *Facts*. Corporation *P* is the parent of a consolidated group whose taxable year is the calendar year, and corporation *M*, a member of that group, is a dealer in securities within the meaning of section 475(c)(1). Corporation *M* regularly acts as a market maker with respect to common and preferred stock of corporation *P*. Corporation *P* has outstanding 2,000,000 shares of series *X* preferred stock, which are traded on a national securities exchange. During the business day on December 29, 1997, corporation *P* sold 100,000 shares of series *X* preferred stock to corporation *M* for \$100 per share. Subsequently, also on December 29, 1997, persons not related to corporation *M* engaged in significant trading of the series *X* preferred stock. At the close of business on December 30, 1997, the fair market value of series *X* stock was \$99 per share. At the close of business on December 31, 1997, the fair market value of series *X* stock was \$98.50 per share. Corporation *M* sold the series *X* stock on the exchange on January 2, 1998. At all relevant times, corporation *M* and all persons related to *M* owned less than 15% of the outstanding series *X* preferred stock.

(B) *Holding*. The 100,000 shares of series *X* preferred stock held by corporation *M* are not subject to mark-to-market treatment under section 475(a) on December 29, 1997, because at that time the stock was held for less than one full business day and is therefore treated as properly identified as held for investment. At the close of business on December 30, 1997, that prohibition on marking ceases to apply, and section 475(b)(3) begins to apply. The built-in loss is suspended, and subsequent appreciation and depreciation are subject to section 475(a). Accordingly, when corporation *M* marks the series *X* stock to market at the close of business on December 31, 1997, under section 475(a) it recognizes and takes into account a loss of \$.50 per share. Under section 475(b)(3), when corporation *M* sells the series *X* stock on January 2, 1998, it takes into account the suspended loss, that is, the difference between the \$100 per share it paid corporation *P* for that stock and the \$99-per-share fair market value when section 475(b)(1) ceased to be applied to the stock. No deduction, however, is allowed for that loss. (See § 1.1502-13(f)(6), under which no deduction is allowed to a

§ 1.475(b)-2

26 CFR Ch. I (4-1-10 Edition)

member of a consolidated group for a loss with respect to a share of stock of the parent of that consolidated group, if the member does not take the gain or loss into account pursuant to section 475(a).)

(c) *Securities deemed not held for investment; dealers in notional principal contracts and derivatives.* (1) Except as otherwise determined by the Commissioner in a revenue ruling, revenue procedure, or letter ruling, section 475(b)(1)(A) (exempting from mark-to-market accounting certain securities that are held for investment) does not apply to a security if—

(i) The security is described in section 475(c)(2) (D) or (E) (describing certain notional principal contracts and derivative securities); and

(ii) The taxpayer is a dealer in such securities.

(2) See § 1.475(d)-1(b) for a rule concerning the character of gain or loss on securities described in this paragraph (c).

(d) *Special rule for hedges of another member's risk.* A taxpayer may identify under section 475(b)(1)(C) (exempting certain hedges from mark-to-market accounting) a security that hedges a position of another member of the taxpayer's consolidated group if the security meets the following requirements—

(1) The security is a hedging transaction within the meaning of § 1.1221-2(b);

(2) The security is timely identified as a hedging transaction under § 1.1221-2(f) (including identification of the hedged item); and

(3) The security hedges a position that is not marked to market under section 475(a).

(e) *Transitional rules—(1) Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts before January 23, 1997—(i) In general.* The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(A) Stock in a corporation that the taxpayer controls (within the meaning of paragraph (e)(1)(ii) of this section); or

(B) A partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust that the taxpayer controls (within the meaning of paragraph (e)(1)(ii) of this section).

(ii) *Control defined.* Control means the ownership, directly or indirectly through persons described in section 267(b) (taking into account section 267(c)), of—

(A) 50 percent or more of the total combined voting power of all classes of stock entitled to vote; or

(B) 50 percent or more of the capital interest, the profits interest, or the beneficial ownership interest in the widely held or publicly traded partnership or trust.

(iii) *Applicability.* The rules of this paragraph (e)(1) apply only before January 23, 1997.

(2) *Dealers in notional principal contracts and derivatives acquired before January 23, 1997—(i) General rule.* Section 475(b)(1)(A) (exempting certain securities from mark-to-market accounting) does not apply to a security if—

(A) The security is described in section 475(c)(2) (D) or (E) (describing certain notional principal contracts and derivative securities); and

(B) The taxpayer is a dealer in such securities.

(ii) *Exception for securities not acquired in dealer capacity.* This paragraph (e)(2) does not apply if the taxpayer establishes unambiguously that the security was not acquired in the taxpayer's capacity as a dealer in such securities.

(iii) *Applicability.* The rules of paragraph (e)(2) apply only to securities acquired before January 23, 1997.

[T.D. 8700, 61 FR 67720, Dec. 24, 1996, as amended by T.D. 8985, 67 FR 12865, Mar. 20, 2002]

§ 1.475(b)-2 Exemptions—identification requirements.

(a) *Identification of the basis for exemption.* An identification of a security as exempt from mark to market does not satisfy section 475(b)(2) if it fails to state whether the security is described in—

(1) Either of the first two subparagraphs of section 475(b)(1) (identifying a security as held for investment or not held for sale); or